All to play for in the US toy market: In less than two years eToys has gained a lead that would-be competitors will find hard to make up TIM JACKSON

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Abstract:

Internet entrepreneurs, like owners of labradors, seem to live life more quickly than most other people. Just as dog owners know that their pet will age the equivalent of seven years during a single year of a human's life, the same is true of web businesses. eToys, an online retailer of children's products that went public in the US last week, is a perfect case in point. 1

Two years ago, eToys was little more than a concept in the minds of two men - Toby Lenk, a former Disney vice-president aged 35, and Bill Gross, a venture capitalist whose IdeaLab company has spawned more than two dozen internet start-ups. IdeaLab had agreed to fund Mr Lenk's ambition to create an online rival to Toys R Us, the American toy retailing group. 2

As the uncle of several small children, Mr Lenk knew that most US adults do not find buying toys fun. With $500,000 (£310,000), he believed, it might be possible to set up an online toy retailer that could compete on price with the industry leader's $5bn in fixed assets. 3

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Better still, he believed an online retailer could combine the best of two different kinds of toy store - a wide range of mass-market products and also the more improving niche products in which smaller and more upmarket retailers specialised. 4

Mr Lenk was also convinced that an **online** retailer could, by using web technology, make the **shopping** process itself easier and more satisfying. Customers could search for products not just by brand or name, but also by age of child, type of product, or price. And the store could bring to the mass market new products from untried makers. 5

This was the vision when eToys opened its doors at the end of summer 1997. 6

When its launch was covered in this column, the company was about to sign a $3m deal with AOL that would give it prominent promotion across the world's biggest online service. 7

Two years on, the company's payroll has grown from under 20 to more than 300 people, and its revenues from under $1m in the year ended March 1998 to $30m in the following financial year. The company also has 365,000 customers. 8

Consistent with Mr Lenk's belief that efficient fulfilment of orders is one of the core skills of internet business, the company runs its own warehousing and pick-and-pack operations. But eToys is outgrowing its 60,000 sq ft warehouse in California, and has signed a lease on 439,000 sq ft in Virginia. 9

At first sight, the company's initial public offering last week provides tempting ammunition for the view that the Web is economics gone mad. Investors buying shares online bid up the company's stock from an offering price of $20 to a peak of $85, valuing the company last Friday at around $7bn. 10

Yet eToys has some issues that would make investors shy away from valuing a traditional business at $7bn. Its gross margins in the first quarter of 1999 were only 19 per cent. It lost $270,000 in inventory because of theft, depressing for a company whose facilities need not be open to walk-in trade, and which has the opportunity to design security systems from scratch. 11

The eToys business also looks more seasonal than other toy retailers - sales in the Christmas 1998 quarter were 20 times those of the previous three combined. 12

Then there is the question of profitability. On its $30m of sales, the company lost around $28.6m - giving an accumulated deficit of more than $30m. 13

But there are two key things that justify investors' optimism. One is that its raw growth rate shows how quickly an attractive proposition can gather customers by word of mouth. 14

The other is that eToys has a big lead not only over other start-ups but also against retailers like Toys R Us and against attempts by the brand owners to sell their products online directly to consumers. eToys already has a number of great features that make it a good place to buy 9,500 different toys, games, music and videos. These include clever merchandising, a birthday reminder service, the longest customer service hours in the business, and **wish lists** in which children and their parents can e-mail grannies with requests. 15

Can competitors imitate all this? Certainly, but the key issue for investors is how many new things, and how many new customers, eToys will have picked up by the time they do so. 16

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Tim Jackson is founder of QXL.com, an online auction business. e-mail tim.jackson@pobox.com

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